



NATIONAL DEFENSE UNIVERSITY

STRATEGIC FORUM

INSTITUTE FOR NATIONAL STRATEGIC STUDIES

Number 165, July 1999

U.S.-European Union Relations: *Economic Change and Political Transition*

by Steven Philip Kramer and Irene Kyriakopoulos

Conclusions

- The European Monetary Union (EMU) will affect the economic balance of force between the European Union and the United States.
- The introduction of the euro as the currency of the EMU will aid participating European Union (EU) member states by eliminating transaction costs, exchange rate risks, and interest rate spreads across the 11 European currencies early in the coming century.
- The proportion of international transactions and assets held, in euros, could approximate that held in dollars within 10 years.
- The U.S.-European political relationship is increasingly disconnected due to the lack of a common external threat, with the United States being concerned about threats to global security and European states focusing on the EMU and unemployment problems.

U.S.-European relations are going through a period of fundamental readjustment. In the economic and financial arena, the introduction of the European Monetary Union (EMU) creates the conditions for a truly supranational European identity and, ultimately, a change in the economic balance of forces between the European Union (EU) and the United States. In the political arena, the U.S.-European political relationship is becoming increasingly disconnected.

The introduction of the euro, as the currency of the EU, is an event of historic importance for European economic integration and for the worldwide financial system. With the implementation of the first stage of this economic union last January, the EMU is transforming the world of business, commerce, and finance. Conversion rates of the 11-country national currencies have been irrevocably fixed, and the euro is trading in foreign exchange and money markets; the European Central Bank has started to operate; new financial instruments, including bank accounts, are issued in euros; and accounting, retail pricing, and business invoices in euros are used in parallel with national currencies. Euro notes and coins are being produced for circulation in 2002, when they will replace national currencies. By July 1, 2002, the euro will be the only form of legal tender in participating member states. With economic integration thus expanded, Europe's experiment with a supranational union is moving into a

20011005 189

new phase. The relationship of the EU with the United States is likely to change, as Europe's growing financial, commercial, and economic clout affects the distribution of resources on a global scale.

The Effect of the EMU on the European Identity

The significance of the EMU in forging a more dynamic European identity should be evaluated in terms of its impact on the international economic system. The economic space of the EU involves 300 million inhabitants and commands a gross domestic product (GDP) larger than the United States' even though it has yet to match America in terms of per capita income. Internationally, the EU is the world's largest trading partner, but nearly two-thirds of international transactions involve the U.S. dollar. The EMU will alter these relationships.

For a number of reasons, the advent of the EMU implies an erosion of the dominance of the U.S. dollar in international trade and finance; the euro's importance will eventually match that of the dollar. By replacing 11 European currencies, the euro will become a key international reserve currency. More significantly, the absence of transaction costs, exchange rate risks, and interest rate spreads across the EU can stimulate the development of a truly integrated financial market in the whole range of financial instruments and activities, including securities trading, pension funds, retail banking, and insurance. According to estimates prepared for the European Commission, within 10 years the proportion of international transactions carried out in euros and assets held in euros will approximate the amount currently held in dollars. Portfolio shifts will also take place as the supply of financial assets in euros continues to grow. Non-EU countries will be affected by the euro, most directly via international trade relations. Trade is expected to increase gradually but steadily as a result of economic growth following completion of the EMU. Indirect effects may be even more profound and global because the euro will serve as a vehicle currency (one that facilitates financial transactions) in foreign exchange markets, and as an invoicing currency (one that facilitates billing) in international trade, with a growing role in capital markets.

The Trade and Investment Relationship

The importance of the trade and investment relationship between the United States and the EU is likely to grow in the new tripolar international financial environment dominated by the U.S. dollar, the European euro, and, to a lesser extent, the Japanese yen. The ascent of the euro as a key currency in the conduct of international transactions will make it more difficult for the United States to run large external deficits financed by the issue of dollars, since there would be less demand for them. Correspondingly, the EMU would find it easier to run external deficits without a depreciating currency. In practice, the EU would likely run smaller trade surpluses as the United States reduced its trade deficit. As a consequence, there will be increased pressure for fiscal policy coordination among European countries. By the same token, the United States and the EU will need to develop cooperation between the Federal Reserve and the European Central Bank in monetary policy.

These developments are likely to lead to realignment of economic priorities and may necessitate change in policy choices. A successful transition to a single currency will reward the efforts of EU member states toward economic convergence but it does not address the critical problem of unemployment in Europe which has remained unacceptably high throughout the 1990s. The choice of pursuing a looser monetary policy and a weaker euro cannot be ruled out now that center-left governments are the norm in the EU; in fact, this may become the

policy of choice. Under appropriate conditions, a weak euro would promote higher growth and lower unemployment; in this case, a weak euro would pose an even stronger challenge to the dollar to the extent that it would enhance the utilization of resources in Europe's economy.

Strong versus Weak Euros

There are some indications that the EU is considering a more lenient interpretation of the inflation criterion in assessing future EMU membership. Such a move may be necessary, because the challenge facing all EU member states is not one of price stability; it is the poor record of most EU economies in creating jobs and reducing unemployment. If these concerns are shared by the European Central Bank and incorporated in its euro-dollar exchange rate policy, they could help promote a weaker euro and ultimately reduce unemployment rates. However, a weaker euro, that would further improve Europe's trade position, would give rise to stronger calls for protectionism in the United States. Such developments might represent something greater than simple inconvenience and could force a change in America's domestic economic policy priorities; measures to reduce the trade deficit would require continuing fiscal discipline and budgetary restraint.

For the United States, success of the euro is important because it will help modernize and strengthen the economy of Europe which remains America's most important trading partner. At the same time, the euro's success will require long-term adjustments. The ability of the United States to sustain its large trade deficit position will be constrained by reduced financial inflows, and measures to offset inflationary pressures might ultimately become necessary. The greater the success of the euro, the more certain it is that U.S. financial supremacy will be challenged and its economic policy reoriented accordingly.

Thus, Europe's transformation into a truly unified economic space will inevitably lead to a change in the EU-U.S. relationship in the 21st century. Economic transformation has security dimensions. If EMU is a prelude to European political unification and paves the way for the creation of a truly supranational European identity, it can lead to realignment in the distribution of power in the international system as a whole. The resulting changes, which will be gradual and incremental but also inevitable, can influence international security relationships.

A Divergent Political Relationship

The development of the EU as a truly unified economic space is occurring even as the U.S.-European political relationship is becoming increasingly disconnected. The dissolution of the USSR ended a period in which a massive and immediate threat to the common interests of the United States and Western Europe forged an enduring bond. Although tensions between the United States and Europe existed, the necessity of their security relationship could not be challenged. NATO was the instrument of the U.S. role in Europe and the only real instrument of European security. The European Community was an economic organization with a political but not a security dimension.

The situation is dramatically different today, for several reasons. First, NATO is now an optional alliance. It provides insurance against a resurgence of the Russian threat and against new but ill-defined future threats of a lesser scale. For this reason, America has supported NATO enlargement and a new strategic concept emphasizing common Western interests, rather than territorial defense, as a primary NATO function. This has been based as much on an American desire to remain a European power as a response to genuine outside threats. It

has been aimed at a domestic audience as well, for internationalists fear isolationist feelings lurking in the American people. Second, the discipline of bipolarity imposed by Cold War has eroded. As the Cold War recedes, historical fault lines reappear along with rancorous partisan politics in some nations. The presidential impeachment process exemplified this trend in the United States and in Russia. Third, the EU assumed a security and defense identity at Maastricht in 1991 and European cooperation on foreign, security, and defense cooperation is greater than before.

Intra-European Focus. There are currently two great disconnects in U.S.-European relations—Europe's preoccupation with intra-European affairs and its concurrent desire to control its own destiny. The first disconnect is that the United States wants Europe to do more on global security but Europe is generally reluctant. There has been a civilianization of much of European society, an allergy to the use of force as an instrument of foreign policy, especially notable in Germany and in the North. Europe is inward-looking, its plate full of grave and weighty concerns. The EMU, the greatest European initiative in decades, has required years of discipline, commitment, and sacrifice and cannot be allowed to go awry. Unemployment has become the big problem of Europe. Failure to resolve it has led to the defeat of ruling parties and their leaders. But the victors know that the clock is ticking and that it is not far from the capitol to the Tarpeian rock.

There is an increasing willingness to attempt to deal with the politics of unemployment and economic growth on a European level. Indeed, it is likely that the European solution will involve a more centrally inspired EU intervention rather than an American-style free market approach. The rise of extremist and fascist parties, like the French National Front, has resulted mostly from the failure of governments to deal with the politics as well as the economics of unemployment. Then there is the crisis of the welfare state, which no one wants to tackle head on.

Still, something far more profound is also occurring. For hundreds of years, the essence of West European history has been the rise of nation states and their eventual democratization. But history is on the move again. Economic integration is evolving in a climate of political devolution. The nation state is caught between loss of power from above—first to NATO and then to the EU—and now from below—to assertive regional and subnational loyalties.

We cannot assume that even states in Europe and elsewhere which have seemed firm and eternal will continue to exist as we have known them. Canada, as the Quebec elections indicate, could dissolve. In Italy, federalist and even separatist feelings are palpable in the North, and a new constitution still needs to be written. In Spain, the political system may need to be revised to increase the already considerable powers of the Basque and Catalan governments. In Belgium, the power of the regions is already great, and the central government is more and more shadowy. Finally, in the UK, Prime Minister Tony Blair has undertaken risky and fundamental changes of the unwritten constitution and has begun the process of devolution in Scotland and Wales. This has already led to a separate regional parliament for each, and there is a real potential for Scottish independence.

At the same time, even though EU enlargement is unavoidable (and the EU is officially committed to it), the EU is displaying great reluctance and hesitation; therefore, the process is delayed. Enlargement requires renegotiation of the basic institutional structure of the EU and its finances, which strains the political will of member states. If we admit that all politics is local politics, we can understand why Europe is preoccupied with these issues and, therefore,

reluctant to shoulder more responsibilities elsewhere, as the United States would like.

Security Responsibility versus Security Burden. The second disconnect, which is often perceived to be in contradiction with the first, is that Europe wants greater control over its own destiny. It is tired of being an economic giant but a political dwarf. To the American thesis that European security is best treated in the Atlantic framework, with NATO as the main instrument and the United States as the leader, there exists a rival thesis of a European Europe—that the EU should take more responsibility through its own security and defense identity. The proponent of that thesis, not surprisingly, is France. Alone of the old nation states of Europe, France did not accept its demise as a global player. Recognizing the limited capacities of a mid-sized state, it transposed its ambitions to the EU. The EU was seen as a France writ large.

The French ambition is plausible but suffers from two defects. First, in general, Europeans still want the United States around. Second, Europe is not anxious to assume the greater burden and responsibility this thesis implies. The result will be continuing European ambivalence between the American and French points of view, usually manifesting itself over specific crises, such as policy toward Iraq and the use of unilateral sanctions. Therefore, tensions between the United States and Europe, and more particularly between the United States and France, will continue.

In conclusion, we can anticipate a difficult period of transition marked by serious tensions in U.S.-European relations. It may be tempting to interpret the successful termination of the NATO air campaign against Yugoslavia as a sign that strong common interests prevail; that the transatlantic relationship between the United States and Europe reflects solidarity, consensus, and a single world view; and that the future of U.S.-European relations rests firmly on the shared heritage of global market economics and liberal democratic politics. Yet achievement of NATO's stated aims will still mean that the United States and Europe will have to face and solve the complex and costly problems of a regional settlement, to include rebuilding of Yugoslavia. Europeans may decide to develop the capacity to defend their security interests, but it is uncertain that the hard budgetary decisions will be made to support such a decision. Also, financial volatility and economic turmoil generated by the war in the Balkans could endanger the euro. American hesitation toward future financial initiatives and contributions aimed at regional reconstruction in the Balkans could further complicate relations. Failure to achieve short-term political objectives and long-term economic development goals could be a source of open discord in both NATO and the EU.

Recommendations

- If the United States values the transatlantic economic, political, and security relationships it developed during the Cold War, it should become more cognizant of the changes the European Monetary Union will bring to world financial and trade markets and take the steps needed to accommodate the competition this will engender.
- Discrepancies between the global view of security threats held by the United States and the intra-national economic and unemployment view of the EU states should be accepted as practicable differences in sovereign viewpoints. The United States should continue to urge the EU states to pay attention to rising global or regional threats that may affect EU interests as significantly as unemployment or financial union.

- Policymakers should bear in mind that the political nature of, and the political boundaries of, even its closest transatlantic allies are subject to change.

Steven Philip Kramer is Professor of Grand Strategy and Irene Kyriakopoulos is Professor of Economics at the Industrial College of the Armed Forces, National Defense University. For more information call Dr. Kramer at 202-685-4213 or Dr. Kyriakopoulos at 202-685-4384. Opinions and conclusions expressed or implied in this paper are solely those of the authors and do not necessarily represent the views of the National Defense University, Department of Defense, or any other government agency.

The Strategic Forum provides summaries of work by members and guests of the Institute for National Strategic Studies and the National Defense University faculty. These include reports of original research, synopses of seminars and conferences, the results of unclassified war games, and digests of remarks by distinguished speakers.

Editor in Chief - Hans Binnendijk

Editor - Jonathan W. Pierce NOTE

| [Return to Top](#) | [Return to Strategic Forum Index](#) | [Return to Research and Publications](#) |

[Return to NDU Homepage](#)
[INSS Homepage](#)

INTERNET DOCUMENT INFORMATION FORM

A . Report Title: U.S. –European Union Relations: Economic Change and Political Transition

B. DATE Report Downloaded From the Internet: 09/21/01

C. Report's Point of Contact: (Name, Organization, Address, Office Symbol, & Ph #):
National Defense University Press
Institute for National Strategic Studies
Washington, DC 20001

D. Currently Applicable Classification Level: Unclassified

E. Distribution Statement A: Approved for Public Release

F. The foregoing information was compiled and provided by:
DTIC-OCA, Initials: __VM__ Preparation Date 09/21/01

The foregoing information should exactly correspond to the Title, Report Number, and the Date on the accompanying report document. If there are mismatches, or other questions, contact the above OCA Representative for resolution.